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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE and SHEILA MACRAE,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

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Petitioners pray that this Court grant a rehearing of its order of January 8, 1962, denying a petition for a writ of certiorari, and that a writ of certiorari issue to review the judgment of the Court of Appeals for the Ninth Circuit in this case as prayed for in the petition filed on November 24, 1961.

This petition for rehearing is filed to call to the Court's attention a reason for granting certiorari which was not previously urged and which counsel regard as of significant and, we suggest, determinative impor-

tance: That reason is the necessity for this Court to dispel the existing confusion as to the application of this Court's decision in *Knetsch* v. *United States*, 364 U.S. 361 (1960), in relation to the nondeductibility of interest payments in connection with loans made to finance securities transactions.

By ruling upon this point, in the context of the present case, we believe this Court will avert further conflict, discrimination and injustice in the rulings of the lower courts, as evidenced in part by the conflict between the Tax Court's decision in *Stanton* (April 7, 1960) and in the present case, decided five days later.

This is a matter of great importance to many taxpayers and to the securities business of the nation.

PRELIMINARY

This case involves the deductibility of interest under Section 23(b) of the Internal Revenue Code of 1939. In four different transactions, petitioner[1] placed orders with Cantor, Fitzgerald & Co., herewith referred to as C-F, brokers and dealers in securities, for the purchase of U. S. notes and Federal Land Bank bonds. C-F either loaned the petitioner the funds to acquire them or arranged for petitioner to borrow the funds from a correspondent, Gibraltar Financial Corporation. C-F then bought the securities for petitioner's account. Petitioner executed and delivered promissory notes for the purchase price and prepaid interest on these notes to their maturity. The notes were with recourse.[2]

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[1] Albert Gordon MacRae is referred to hereinafter as the petitioner, his wife being a party only because joint returns were filed for the taxable years involved.

[2] The first promissory note was initially without recourse. It was shortly converted to a recourse note.

The Tax Court described the first note as giving the lender a lien upon the securities pledged as collateral and the right to rehypothecate or borrow the collateral in a manner not inconsistent with MacRae's ownership of the securities. MacRae never gave anyone authority to sell for his account until 19 months after the first purchase.

The transaction was similar to hundreds or thousands of securities transactions that take place every day. The loan was bona fide; petitioner was personally liable for its payment; petitioner ordered the purchase of the securities like any purchaser, and the securities were actually purchased by a registered broker-dealer for his account. This was not a "sham" transaction. There was no "wash-out" so far as petitioner was concerned. He actually borrowed money; he actually bought securities. He did not sell any of the securities until 19 months after the first purchase.

The Tax Court, however, relied upon an event *which has no relation to the taxpayer* and of which the Tax Court itself found *the taxpayer had no knowledge*.[3] This is the fact that C-F, or Gibraltar, *without the knowledge of petitioner* and not for his account sold the securities on the same day that it purchased them.[4]

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[3] The Tax Court opinion states: "Petitioners urge that they had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar, and we believe this to be true." 34 T.C. at 27.

[4] The broker sold short similar securities for its own account, borrowing MacRae's securities in that connection, but MacRae knew nothing of the broker's short sale. So far as he knew, the securities were held as collateral for his loan. The sale could not have been made for MacRae's account since he had not authorized it. A customer has no means of preventing a broker from selling

The Tax Court relied upon the immediate sale of the securities to reach its result. It held that the sale of the securities showed that the transaction was an "essential nullity." Then, *despite its finding that the petitioner knew nothing about all this*, the Tax Court used this as the reason for disallowing the deduction to the unknowing petitioner. The SEC apparently regards such a transaction as a loan; once securities are purchased and held for the customer's account against payment, a loan has been made; and an immediate sale by the lender does not nullify the loan. See *Appendix A, infra.*

Obviously, we submit, the principle established by this holding, approved by the Ninth Circuit, is intolerable: It is that a person who borrows from a broker or dealer to effect a purchase of securities is in effect held not to have borrowed the money, because of the latter's wholly unrelated actions—*even if the borrower is ignorant of them.*[5] This principle is not only unjust and unlawful, but if followed, will place a burden upon purchasers of securities which should and will discourage a typical and common form of trading.

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the same securities as are held for his account. See Perry A. Nichols, 37 T.C. No. 74 (1962).

The sale was undoubtedly made to allow the broker to avoid the interest expense which would have been incurred had the notes been rehypothecated and funds borrowed to finance the loan made to petitioner. The short sale permitted the lender to achieve a greater profit on the transaction.

[5] In *Perry A. Nichols, supra*, the Tax Court found the taxpayer chargeable with the broker's or dealer's actions and the loan a "sham," even when the broker expressly represented that he would not sell the taxpayer's securities short, and subsequent correspondence from the dealer erroneously indicated that the securities were being held as collateral for taxpayer's loan.

The Tax Court, as affirmed by the Court of Appeals, also grounds its characterization of the loan as "sham" on the proposition that one engaging in a "commercial transaction," must have a reasonable expectation of profit before taking into account the tax effect of the transaction.[6] The only true economic profit on a transaction is that remaining after taxes. If all loans are to be subjected to the novel test relied upon by the Tax Court, the *MacRae* decision has opened a very broad area of uncertainty in many commercial transactions. Almost every time a person buys U. S. securities on margin he weighs the relative value of the expected capital gain, after taxes, against the net cost of interest, after taxes. Absent the tax effect, many thousands of such margin transactions do not produce profit and are not expected to do so. *MacRae* would make all these transactions "sham."

Accordingly, this case presents the important question whether a transaction which, so far as the taxpayer is concerned, involves a bona fide loan on which interest is bona fide paid, should be treated as a sham because of the action of the broker or dealer, to which the taxpayer was a stranger, and of which he was entirely ignorant, and or because the transaction may have produced a profit only after the application of the tax rates.

The lower courts also relied on *Knetsch* to hold that a loan in this sort of transaction should be so treated.

[6] Petitioner obviously entered to the transactions with the hope of an economic benefit. The expected gain on the disposition of the securities, even after paying capital gains tax, was greater than the net cost of the interest paid—that is after taking account of the cost of net interest (interest paid less interest received) after the deduction of the net interest from taxable income.

We submit that the present case clearly presents the problem of misconstruction and misapplication of *Knetsch*, and that it is of great importance that this Court rule on the questions presented. Even in the very specific area of transactions motivated by and carried out, quite like the present, the question is important, and the lower courts' lack of clarity as to *Knetsch* is leading to conflicting and confusing results. A striking example of this appears upon comparing the Tax Court's decision in *Stanton* with the decision in the present case. See *infra*.

REASONS FOR GRANTING THE WRIT

1. The decision below is a misapplication of the decision of this Court in *Knetsch* v. *United States*, *supra*. There is evidence that this Court itself appreciated that *Knetsch* might require further elaboration.[7] In *Knetsch*, the petitioner himself engaged in a "sham" transaction. He was not really obligated to pay interest, nor did he in reality buy an annuity in anywhere near the amount purportedly involved.[8] This is the point of the decision. The fact that the transaction was tax motivated was expressly "put aside" and was not a basis for the decision.

The lower courts, however, have applied the reasoning of the *Knetsch* decision in a situation like the pres-

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[7] As Justices Douglas, Whittaker, and Stewart pointed out in their dissenting opinion in *Knetsch*, "To disallow the 'interest' deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here." 364 U.S. at 371

[8] In *Knetsch*, the taxpayer purported to borrow over $4,000,000 to acquire an annuity which would be worth $1000.

ent case where parties have borrowed to acquire securities, which were undeniably worth what was paid for them, and where the interest was undoubtedly paid and not partially refunded." In other indistinguishable situations the lower courts have allowed the interest deduction. *L. Lee Stanton* v. *Commissioner*, 34 T.C. 1 (1960), appeal dismissed (1961).[10] See also *Hood* v. *Commissioner*, 20 T.C.M. 1140 (1961); and *Sadie S. Friedman* v. *Commissioner*, 34 T.C. 456 (1960).

The present case and the Tax Court's decision in the *Stanton* case illustrate the confusion in the present state of the law on interest deductions.

The lower courts in the present case have characterized the loans as a "sham," because the broker or dealer sold MacRae's securities for their own account—without his knowledge—rather than incurring interest expense themselves on the sums they had advanced to MacRae.[11] So far as MacRae knew, the broker or dealer was holding the securities as his property, pledged as collateral for his loan. In the *Stanton* case, decided for the taxpayer, the only differences in fact

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[9] *Kaye* v. *Comm'r*, 287 F. 2d 40 (9th Cir. 1961); *Perry A. Nichols*, *supra*; and the present case.

[10] The variety of views concerning the proper treatment of the interest deduction is further illustrated by the fact that there were four separate opinions in the Tax Court in the *Stanton* case.

[11] The Tax Court makes something of the circumstance that MacRae's creditors did not have adequate funds to make the loans. There is no basis for assuming that MacRae knew this. In any event, brokers often borrow money to carry the accounts of their customers. There is no reason to believe that the broker or dealer here involved could not have rehypothecated the securities and borrowed on them. However, they obviously could make more money by selling the securities, knowing that they could reacquire them any time they needed them, as they did.

are that Stanton borrowed the money from a bank and not from his broker or a correspondent of his broker (Gibraltar), and the bank, which loaned Stanton the price of his securities with prepaid interest, held the securities as security for the duration of their loan. The latter circumstance is clearly immaterial. The deductibility of interest by borrowers cannot depend upon how lenders handle their affairs. Cf. *Dallas Downtown Development Co.* v. *Commissioner*, 12 T.C. 114 (1949).

There is no rational basis for a distinction between the two situations in the fact that MacRae borrowed from the broker or dealer and Stanton from a bank.[12] In neither case did the borrower receive the cash or possession of the securities, which were collateral for the loan. In both cases the total interest was prepaid. These arrangements are common in securities margin transactions,[13] regardless of the identity of the lender. If the courts regard the identity of the lender as an important factor, or perhaps the determining factor,[14] then money will be borrowed from brokers for margin

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[12] "Surely, the application of the tax laws does not depend upon the source of borrowing." J. Moore, in *Diggs* v. *Comm'r*, 281 F. 2d 326, 332 (2d Cir. 1960), cert. denied, 364 U.S. 908.

[13] ". . . a bank will buy securities for a customer and make a loan against the securities as collateral. The customer usually never sees money or securities." *Diggs* v. *Comm'r*, *supra*, at 331. See also *Kraft Foods Company* v. *Comm'r*, 232 F. 2d 118, 122 (2d Cir. 1956). So will brokers make a loan against the purchase of securities and the customer will not see the money or the securities.

[14] See *Sadie S. Friedman* v. *Comm'r*, *supra*; *Clifford Hood* v. *Comm'r*, *supra*; *John T. Loughran*, 19 T.C.M. 1193 (1960), appeal dismissed (4th Cir. 1961). See also the Commissioner's Brief in opposition to the petition for certiorari, pp. 13-14. In the *Loughran* case, interest was allowed to be deducted which was paid on a bank loan to finance the purchase of an annuity as in *Knetsch*.

purchases of stocks and commodities and similar transactions only at the peril of the borrower. He may find that because of the action of the broker-dealer, unknown to him, he will be denied deductibility of interest. The deductibility of interest paid on the loan is too important in our present income tax system to allow such a result without serious repercussions.

The confusion of the lower courts is made apparent by the irrational and arbitrary variation in results in such cases as the present one and *Stanton* and those cases which follow *Stanton*. Court decisions, in relying upon such meaningless distinctions as the identity of the lender and the completely unrelated conduct of the lender, acting for its own account (even where that conduct was unknown to the taxpayer),[13] have completely lost sight of the basic teaching of *Knetsch*. The determinative factor in *Knetsch* is that the loan there was a "sham" because it did not involve a real payment of interest and was arranged to acquire nothing of realistic value, *not* that the lender was an insurance company rather than a bank.

In the present case, MacRae obtained securities which were worth the amount borrowed and whose sale produced a capital gain. He actually paid the interest on the loan, upon which he was individually liable. This is the transaction, so far as he is involved. The loan was, therefore, no "sham," whether or not we postulate that the petitioner was tax motivated. The *Knetsch* decision itself makes it clear that no consequences attach to the fact that the loan would not have been made except for the variation of the tax rates appli-

[13] The four dissenting Judges of the Tax Court in the *Stanton* case could see no distinction between that situation and *MacRae*.

cable to the deduction for interest payments and the gain on the sale of securities.[16]

2. The urgent need for clarification is emphasized by the present posture of cases of this sort. The *Stanton* case was decided for the taxpayer on April 7, 1960. Five days later the *MacRae* decision was decided for the Commissioner. As demonstrated above, there is no rational distinction between *MacRae* or the very recent *Nichols* decision[17] and *Stanton*. An appeal to the Second Circuit was filed by the Commissioner from the decision in *Stanton*, apparently because the Tax Court decided *Stanton* for the taxpayer in obvious conflict with *MacRae*. But then the Department of Justice dismissed the appeal in Stanton. Presumably the Commissioner now has the hopeless task of ruling upon other cases on the basis of *both Stanton* and *MacRae*! Certainly it would be a boon to all concerned if this Court will now rule on the problem and in so doing, clarify the application of *Knetsch* to this type of situation.[18]

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[16] As Justice Brennan stated, "We put aside a finding . . . that Knetsch's 'only motive in purchasing these 10 bonds was to attempt to secure an interest deduction.'" *Knetsch, et al.* v. *United States*, *supra*, at 365.

As Judge Murdock said in *Stanton*, the profit "after taxes" is "the only kind of profit which can do any taxpayer any good." 34 T.C. at 8.

[17] See n. 4, *supra*.

[18] There may also be a denial of due process in the lower courts' taking into account the unauthorized action of C-F as a basis for denying the interest deduction here. In *Hooper v. Tax Commissioner*, 284 U.S. 206 (1931), this Court invalidated a Wisconsin statute as a denial of due process because it subjected a husband to a tax computed on the combined total of his and his wife's separate incomes. There would seem to be an equal denial of due process if one person is denied a deduction because of the action of a third party taken without the person's knowledge and not for the account of the taxpayer.

3. This Court has granted certiorari to consider the claim that the lower courts have distorted principles announced by its decisions. See *Commissioner* v. *Culbertson*, 337 U.S. 733, 735 (1949), in which the claim was that the lower courts had misapplied its earlier decisions[19] in the family partnership area. See also *Commissioner* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1949) where again the Court granted certiorari to clear up doubts arising from its earlier decision in the *Court Holding Company* case, 324 U.S. 331 (1945). The present misapplication of the holding in *Knetsch* makes this Court's intervention imperative so that the Commissioner's efforts to collect tax will be confined to the statutory limits as interpreted by this Court.

4. The whole question of the deductibility of interest payments is one of major importance in the Federal tax system. At the time of the decision in the *Stanton* case, it was one of 13 similar cases pending in the Tax Court. From an inspection of the Tax Court Docket it is apparent that at least 11 more cases have since been filed in the Tax Court alone; and we understand from a statement of the Respondent made in a motion to defer the trial of this case, that there are many hundreds of cases which have not reached the litigation stage. The present case, presenting, as it does, a situation in which money was borrowed to buy valuable securities, provides an excellent vehicle for clarification of this whole difficult area.

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[19] *Commissioner* v. *Tower*, 327 U.S. 280 (1946); *Lusthaus* v. *Commissioner*, 327 U.S. 293 (1946).

CONCLUSION

For the reasons set forth above and in the petition for certiorari, it is respectfully urged that rehearing be granted and that, upon such rehearing, a writ of certiorari issue to the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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Dated: February 1, 1962.

CERTIFICATE OF COUNSEL

Abe Fortas, one of the counsel for the petitioners herein, hereby certifies that the foregoing Petition for Rehearing is presented in good faith and not for delay and is restricted to grounds specified in Rule 58(2) of the Rules of this Court.

APPENDIX A

Excerpts from Wall St. Journal (January 29, 1962, p. 12) on Public Hearing of the SEC on Charges Against Sutro Bros. & Co.

"Mr. Schwartz told the hearing it would be part of Sutro Bros. defense that the loans made to Sutro Bros. by First Discount were 'unsecured' and that therefore they did not violate securities laws and regulations.

How Transaction Worked

"Mr Schwartz said that when First Discount advanced money to a customer of Sutro for the purchase of stock, the stock was immediately sent to a bank, North Jersey Trust Co., for First Discount's account there. The bank then immediately sold the stock on First Discount's instructions, Mr. Schwartz said. Later, when the customer returned the money he had borrowed, First Discount had to go into the open market to buy the stock which it returned to him, Mr. Schwartz said. 'If the stock had meanwhile gone up, First Discount had a loss. If it had gone down, they made some money,' said Mr. Schwartz. North Jersey Trust Co. is located in Ridgewood, N.J.

"Mr. Schwartz added, 'But First Discount never extended any credit on securities, because they never had any. Just about every stock delivered by Sutro Bros. to First Discounts account at North Jersey Trust Co. was promptly sold. First Discount never had any stock as collateral. They were unsecured loans and in no way a violation of the regulations.'

"John J. Devaney, assistant regional administrator of the SEC, replied at the hearing that so far as the SEC was concerned, "Once Sutro Bros. had delivered securities to North Jersey Trust Co. for the account of First Discount Corp. against payment to Sutro from First Discount, the transaction was closed. *An extension of credit had been given, and what was done with the stock afterwards does not concern this hearing.*'" [Emphasis added]

No question of a violation of the margin regulations is involved in the present case since these regulations are not applicable to U. S. Government securities.